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Backgrounder

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Softwood Lumber:
The Next Phase

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The US Commerce Department's recent application of a 13 percent anti-dumping duty on Canadian softwood lumber marks a new phase in the long-standing Canada-US dispute over lumber trade. Canada has many options in trying to end this economically damaging dispute: a negotiated solution that would include a suspension of duties; fighting the decision in US courts; seeking resolution through the dispute settlement machinery of the World Trade Organization; and seeking compensation under the investor protection provisions of the NAFTA. Although the economic dislocation caused by duties makes the negotiated solution attractive, the required combination of managed trade and revised Canadian timber management practices would be hard to achieve, especially in the limited time available. Ottawa, the provinces, and the Canadian industry should therefore press ahead on all available legal fronts, with an eye to ensuring an outcome that sets a better precedent for future trade disputes than has been achieved in the past.

The Canada-US softwood lumber dispute is now in its twentieth year. It is the most significant bilateral trade issue between the two countries, eluding permanent solution over all this time. The dispute originated with the first countervailing duty petition by US producers in 1982 (Lumber I). The result was a finding by the US Commerce Department that Canadian stumpage programs did not amount to countervailable subsidies.

Taking advantage of some changes in US laws, producers in the United States filed a second countervail petition in 1986 (Lumber II). This time, the Commerce Department found that stumpage programs were indeed countervailable. Before the case went to the final phase, a Memorandum of Understanding (MOU) was concluded between the two governments. In return for termination of the proceedings, Canada agreed to apply a 15 percent export tax on all softwood exports to the United States.

Canada exercised its right to terminate the MOU in 1991, as provincial stumpage rates increased and replaced the effect of the 15 percent export tax. Under pressure from interest groups in the United States, the US government began a third investigation (Lumber III). When Canadian stumpage programs were again found to be countervailable, Canada appealed the US subsidy decision to a panel convened under the terms of the

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North American Free Trade Agreement (NAFTA), which upheld the Canadian position by a majority vote but split 3 to 2 along national lines. The US side was outraged and threatened further action.

In 1996, in an attempt to achieve some measure of stability and to resolve this major bilateral problem, the two governments concluded a five-year softwood lumber agreement that capped Canadian duty-free exports at approximately 15 billion board feet annually. When the agreement expired in 2001, US producers again alleged that Canada was engaged in subsidies and dumping, which led to yet another US Commerce Department investigation (Lumber IV). And, once again, on October 31, the department made a preliminary determination that Canadian softwood lumber is being both dumped and subsidized, and applied a 13 percent anti-dumping duty (on top of an earlier countervailing duty for alleged subsidies) to Canadian softwood lumber imports.

Choosing the Best Legal and Policy Options

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The US Commerce Department's decision struck an economic blow to the Canadian softwood lumber industry and revealed both the extent of Canada's exposure to the US trade remedy system and the limitations of the NAFTA dispute settlement provisions in reducing that exposure. Beyond this, it illustrated the value to US producers of using trade laws as a strategic business weapon.

The case underscores the critical dilemma facing the Canadian industry: whether to fight it through various legal avenues or attempt some pragmatic settlement with the US side. This same dilemma existed in Lumber I, II, and III. In Lumber IV, the latest incarnation, Canadian producers generally seem to view pursuing the long-term legal route as the best strategy. But such a long-term strategy does nothing to alleviate the immediate harm done to the Canadian forestry industry, its workers, and the Canadian economy at large by the US contingent duties.

The economic repercussions of significant duty liability and the prospect of these duties becoming permanent in March 2002 is thus putting pressure on the Canadian industry and on both the federal and provincial levels of government to devise some kind of agreed solution. Such a solution inevitably would mean a combination of managed trade and a revision of Canadian timber management practices toward some kind of market-based system. While changes along these lines may be overdue, adjusting practices of long standing under intense time pressure and in the context of a bitter and highly charged bilateral dispute is unlikely to produce a well balanced package. For this reason, independent pursuit of all available legal options, through the US courts, at the World Trade Organization (WTO), and in support of Canfor's Chapter 11 challenge, would be the best policy mix for Canada.

A Negotiated Solution

Notwithstanding the difficulties, efforts are under way to explore the possibility of a negotiated solution through high-level talks. Reports on their continuing progress vacillate between guarded optimism and downright pessimism. As recently as November 19, reports emerged of a plan by the British Columbia government to make radical changes to that province's stumpage system, but even these changes are unlikely to appease an aggressive and possibly implacable US industry.

On the increasingly remote chance that a negotiated solution might work, it could result in what is called a "suspension agreement," which would allow the case effectively to be halted. That is what happened in 1986 and again in 1996, when Canada agreed to a managed system of export taxes and quota limitations. The problem with a suspension agreement is that the clock is ticking and there is a deadline looming for its conclusion. That means that all the complex details would have to be sorted out within a window of about 90 days, making it a difficult practical problem. Trade law is not like civil litigation, where settlements are possible at the foot of the courthouse steps. Resolution of trade disputes is trickier and has to be shoehorned into the precise requirements of the WTO and the time limits set out in national legislation.

Judging from comments by representatives of the US softwood lumber industry, any settlement would not only have to alter radically Canadian forest management practices and laws; it would also oblige Canada to abandon its stumpage system in its entirety to bring the system in line with US ideas of a market-based auction system. That would mean a wholesale alteration of Canada's Crown-owned timber regime and the manner in which economic rents (stumpage fees) are set and collected.

Pending the results of ongoing talks between Pierre Pettigrew, Canada's Minister of International Trade, and special envoy Mark Racicot on the US side, the battle can be joined on other fronts. While none offers immediate relief and none is guaranteed ultimately to be successful, they may help to give Canada some additional negotiating leverage in terms of securing a successful a political settlement.

Policy Considerations versus Daily Pressures

Earlier indications were that the various players in the Canadian softwood lumber industry were united in their determination to fight the case to the very end in the hope of a definitive legal victory. This solidarity may be waning, however, in the face of the seriously negative impact of US anti-dumping and countervailing duties, especially in British Columbia, making it difficult for Ottawa to define the right policy and to stick with it to the end. This economic fallout and the US government's apparent willingness to attempt a deal (as opposed to the recalcitrance of the US industry) make some kind of negotiated outcome an appealing prospect.

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The problem here, however, is threefold. First, assuming some agreement can be reached with the executive branch of the US government, how could such deal appease the various segments of the US industry and their lobbyists, who want both an end to Canadian stumpage programs and some permanent commercial advantage over a competitive Canadian industry? Second, how could any negotiated outcome respect the free trade principles and market access rights enshrined in the NAFTA? In other words, would a deal not simply introduce a new regime of managed trade? And third, assuming Canadian forest management measures would be part of any deal, could the provinces live with it?

Canfor's Dramatic Announcement

A new twist in the softwood lumber dispute occurred on November 5, when Canfor Corp. announced it was filing an arbitration claim, under the NAFTA Chapter 11 investment provisions, seeking $250 million in compensation from the US government.

The approach Canfor is likely to take is to invoke Article 1105 of the agreement, which obliges the US government to accord "fair and equitable treatment" and "full protection and security" in accordance with international law to all Canadian investors and their investments in the United States.

The independent arbitration panel will not make a final ruling on Canfor's claim for some time. However, the claim itself is an important strategic development. It is the first use of Chapter 11 in this kind of trade dispute and therefore breaks new ground by seeking to have trade remedies adjudicated under Chapter 11 investment standards. It also gains negotiating leverage for both Canfor and the entire Canadian softwood industry in the main dispute, and regains some of the initiative from the US side.

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On substantive grounds, the challenge is for Canfor to prove unfair or inequitable treatment of and discrimination against Canadian exports to such a degree as to amount to a breach of the NAFTA by the US government. The task is not an easy one. The United States will argue that it is simply applying ordinary trade remedy laws as sanctioned by the WTO agreements.

On the other hand, if there is evidence that the US Commerce Department responded to political pressure and unfairly targeted Canadian softwood, it might be possible to convince an arbitration panel that the United States has not given Canadian investments the kind of "fair and equitable treatment" that the NAFTA and international law demand. If successful, Canfor could obtain compensation for all the anti-dumping and countervailing duties paid as well as lost profits resulting from the investigation.

Judicial Review under US Law

Another option would be for the Canadian industry to set the stage for a judicial review of the case by the US Court of International Trade by initiating a point-by-point challenge of both the US Commerce Department's methodology and its calculation of the preliminary margins and amounts of subsidy. I return to this below, but it should be noted that WTO dispute panels have already found US dumping methodology to contravene the WTO Anti-Dumping Agreement in other cases, suggesting possible areas where the Canadian side might seek relief in US courts.

A parallel option would be to challenge the claim in the US court system that Canadian imports have caused material injury to US producers. Under WTO rules, dumping and subsidization in themselves are not illegal; it is only where these actions cause material injury that governments can apply anti-dumping or countervailing duties. In many instances, the proof of causation is a forgone conclusion, and the standard is quite low: dumping or subsidization must be just *one* of the causes of material injury, not the only cause. Nevertheless, the evidence must objectively establish this "causal link," and Canadian exporters may have a number of arguments with which to fight causation under US law.

Although causation must be established on a Canada-wide, not on a company-by-company, basis, Canadian exporters might win exclusion from the final US target list if it can be proven that softwood exports from individual Canadian sources have not injured US producers. Again, this may not help Canadian producers in the short term, but it shows that the game is not yet over — the Canadian industry can still fight battles on several fronts, including in US domestic courts.

Fighting It Out at the WTO

Since the WTO agreement came into effect in 1994, major changes have taken place in the multilateral trading system. Under the former General Agreement on Tariffs and Trade (GATT), which the WTO replaced, the application of anti-dumping and countervailing duties was essentially the preserve of governments, and GATT panels rarely interfered. Now, however, instead of injured parties' having to seek relief through domestic courts, national trade agency and tribunal decisions are regularly appealed directly to WTO dispute panels. The panels have been aggressive in examining these decisions to see if they comply with the detailed requirements of the WTO agreement.

As well, there is now a fast-track timeline for dispute settlement at the WTO. While the United States can delay Canada's first request for a panel, it cannot forstall a panel's establishment beyond an initial 30-day period. Once convened, the panel must issue its decision within six months or, in exceptional cases, within nine months. This is also of value to Canada.

Recent WTO Panel Decisions

Illustrative of these changes are a rather remarkable couple of cases where WTO panels scrutinized US dumping decisions in great detail and concluded that the US Commerce Department had breached the requirements of the Anti-Dumping Agreement. While these cases focus on anti-dumping, similar reasoning applies to countervailing duties under the Subsidies and Countervailing Measures Agreement.

In *Stainless Steel Plate and Sheet from Korea* (December 22, 2000), a WTO panel found that the US Commerce Department had breached the Anti-Dumping Agreement, thus nullifying and impairing benefits accruing to South Korea and giving that country the right to retaliate. Similarly, although for different reasons, in *Hot-Rolled Steel Sheet from Japan* (February 28, 2001), another WTO panel found that the Commerce Department's margin determinations had also breached the requirements of the Anti-Dumping Agreement, giving Japan the right to retaliate.

The United States appealed *Hot-Rolled Steel Sheet* to the WTO Appellate Body, which upheld the original panel's decision on several key points. Of interest to Canada is what the Appellate Body said about the role of panels under the WTO Anti-Dumping Agreement. Article 17.6 of that agreement allows WTO panels to determine whether the evaluation of facts by national agencies (such as the US Commerce Department) was *proper, unbiased, and objective*. The Appellate Body said that, if these broad standards had not been met, a panel would have to hold the investigating authorities' establishment or evaluation of the facts to be inconsistent with the agreement.

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The facts of these steel products cases differ from those of the current softwood lumber investigation. But the Appellate Body's legally binding view of the role of WTO panels makes it clear that the US Commerce Department — and, subsequently, the US International Trade Commission — can be put to the test before the WTO. Each case must be fought on its merits, of course, but Canada's softwood lumber industry clearly has some important avenues of redress to pursue under the WTO that were not available under the GATT.

Some Conclusions

There is no easy prescription for settling the Canada-US softwood lumber dispute, and the ground seems continually to be shifting. One encouraging development, following a round of Pettigrew-Racicot talks in Ottawa in early November, is that a deal still seems possible. But more recent indications are less optimistic, with word emanating from US industry sources that it will take radical change to the entire Canadian forestry management system to get the US side to settle.

In the meantime, Ottawa, the provinces, and the Canadian industry have little choice but to pursue a parallel course and aggressively use all available legal means to have the investigation tested both in US domestic courts and at the WTO. Changes in the WTO dispute settlement system, moreover, give Canada some new leverage, while the Canfor Chapter 11 arbitration claim suggests that other options have emerged under the NAFTA. Although any arbitration decision is a long way off, Canfor's success, even a partial one, would have significant repercussions for the entire trade remedy process.

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